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M&A Outlook for 2023 (Part Three)

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As it turns out, there's no better lens through which to examine the effects of the current economic environment than US middle market M&A activity. As we heard last week from five top investment bankers, a wide range of indicators – including volume, valuations, financing and sector rotation – flashed across the market in the wake of interest rate hikes, public asset volatility, and economic headwinds.

Before digging into panel's expectations for this year, let's reprise 2022 highlights. Global M&A volume was down 35% and 11% by deal count, and in the US 41% and 17%, respectively. Sponsored deal flow was off 33% for both volume and numbers, but ahead of 2020 numbers.

The unraveling of deal momentum began as early as last February. Though market "choppiness" didn't take hold until the second quarter when "the bottom fell out of the middle market." September witnessed a comeback with deals moving forward in November. Still, buyers took every opportunity to re-trade deals.

Our panelists did note that while 2022 was off the epic heights of 2021, it was still the fourth or fifth best ever for M&A. Transaction multiples were flat, though US LBO valuations for 2022 still exceeded those of 2021. Selection bias by sector played a role, creating a tale of two markets. "A" assets were still highly prized; "Bs"were a tougher story. Examples of winning sectors, from one banker's perspective, included distribution, MRO's and growth-oriented technology.

Size also mattered. $2 billion-plus transactions were few and far between. The sweet spot was $250 million to $1 billion. Or in one view, "the smaller the size the smaller the degradation of activity levels." Strategics somewhat unexpectedly "did not run the table" last year. Sponsored share of buyouts was the second highest ever.

Large corporate buyers were paying up, able to be more aggressive by not relying on financing markets. Valuations seem to have softened, but that's not yet coming through in the data. Sellers not getting their ask price are simply choosing not to transact.

Industrials are showing a solid backlog of business. 75% of these companies are showing improved or stable performance, with the rest weakening. One bright spot benefiting from multiple demand drivers is the power segment. Those include spending bills passed, grid hardening, and the increasing power needs (e.g. EVs, multimedia) of the consumer.

Finally the higher rate environment with all-in spreads up 100-200 bps makes LBO financing more expensive and lowers debt quanta. Term sheets are one-half to a full turn of leverage lighter, thanks to interest coverage and recession worries. The Fed likely lifts rates to the 5% range, then hangs out for a while.

As our bankers told 650 Lead Left webinar registrants, don't expect to see 2021 debt levels anytime soon.